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TAGS: ECON EFIN EINV ETRD HK CH
SUBJECT: FAITH IN CHINESE STIMULUS, DOUBTS ABOUT DEMAND

¶1. Summary: Hong Kong analysts, financial officials and bankers generally trust that China's fiscal and monetary stimuli will help prop up Chinese GDP growth in 2009 despite rapidly collapsing exports. Most senior Chinese officials understand that declining exports reflect evaporating foreign demand, not loss of competitiveness vis--vis other exporters. Although China has unveiled some symbolic concessions to exporters, most analysts agreed that devaluation of the RMB is unlikely in the near term. Reorienting the Chinese economy away from export-related manufacturing and toward additional domestic consumption will take years; the necessary physical and social infrastructure is still underdeveloped. End Summary.

¶2. U.S. Treasury officials from Washington, Embassy Beijing Financial Minister Counselor and U.S. Consulate General Hong Kong Economic Unit Chief met with Hong Kong-based analysts, bankers, and Hong Kong financial officials February 20-24 to discuss Chinese macroeconomic performance, social stability, banking sector developments and other policy issues, including Hong Kong government preparations for the London G-20 meeting in April (reported septel). All of the above USG participants have cleared this cable.

Stimulus Will Boost 2009 Growth...

¶3. Local economic analysts generally support the Chinese Central government's approach to fiscal stimulus. HSBC Economist Fred Neumann foresees Chinese real estate transaction volumes increasing and believes the destocking process blamed for plummeting regional exports to China is almost complete. Among the most optimistic of local China-watchers, HSBC expects Chinese GDP growth to exceed eight percent by the end of 2009.

But Then What?

¶4. Several of our interlocutors worried, however, that the stimulus package impact on GDP growth would fade by the middle of 2010, well before the Chinese economy is able to reorient its economy away from manufacturing for export toward domestic consumption. The Chinese government can provide more fiscal stimulus without raising concerns about its creditworthiness, said Goldman Sachs economist Michael Buchanan, but policymakers are reluctant to allow their budget deficit to exceed three percent of GDP. Goldman Sachs Managing Director Fred Hu disagreed, and argued that the Chinese leadership will not worry about additional deficit spending, as long they can find reasonable programs to fund. Asianomics CEO Jim Walker noted that China's strong fiscal position allows it to undertake additional government spending, but with government revenues dependent on taxes on real estate transactions, the value added tax (VAT) and corporate taxes, he predicted Chinese government income will

fall sharply this year. (Note: Chinese Ministry of Finance officials told Finatt that three percent of GDP is an "international standard" for a prudent budget deficit. This assertion appears to be drawn directly from Europe's Maastricht Treaty, which was based on Europe's much lower potential growth rate, higher real interest rates, and higher existing debt to GDP ratios. China could in fact run much larger deficits, particularly during a severe cyclical downturn and still maintain sustainable public services. End Note.)

Increasing Bank Lending Key to Stimulus
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¶5. Goldman Sachs Managing Director Roy Ramos believes recent strong growth in lending has been driven more by government moral suasion than by productive investment opportunities. As much as 40 percent of new loans represent short term borrowing, taking advantage of the sharp drop in lending rates on discounted bills to invest in higher CD deposit rates or the Chinese stock markets, Ramos said. Another 10-20 percent reflects the refinancing of high-cost borrowing from non-bank financial institutions during the period of binding credit quotas. Just 40-50 percent of new loans are financing productive infrastructure investments or operating capital expenses, he remarked.

¶6. Chinese banks are getting mixed messages from the Chinese Banking Regulatory Commission (CBRC): lend more, but avoid bad debt. The CBRC does not appear to be directing loans to particular firms or imposing penalties if loan growth falls below target. CBRC pressure is forcing the smaller banks to

face more difficult lending choices. Partially shut out of infrastructure and State-owned enterprise lending, they must turn to the small and medium enterprises (SMEs) to make loans. Goldman Sachs estimates that as many as 20 percent of loans to Chinese SMEs are at risk of falling into non-performing status, based on their earnings before interest, taxes, depreciation and amortization (EBITDA). As bad as that is, said Ramos, China is one of the better performers in the region. By the same measure, 35-45 percent of loans to Taiwan SMEs risk becoming non-performing, he claimed.

¶7. (Note: These views are at odds with what Chinese interlocutors tell Embassy Beijing Financial MinCouns. Most mainland Chinese bankers, regulators, and analysts believe the sharp increase in lending during the first two months of 2009 is not due to moral suasion, but is a commercially rational response to the increase in liquidity resulting from: the decrease in reserve requirements; sales of sterilization bonds; withdrawal of government deposits at the central bank; interest rate cuts on excess reserves in the central bank; and, the lifting of binding credit quotas. Flush with liquidity, and uncertain when credit quotas will again restrict lending, banks have rushed to extend credit to borrowers with implicit central government guarantees, such as state-owned enterprises and National Development and Reform Commission-approved infrastructure projects. End Note.)

Chinese Leaders Won't Try to Protect Exports
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¶8. Senior Chinese officials understand that China's rapidly falling exports are a function of collapsing external demand, not a lack of price competitiveness, said Goldman Sachs' Hu. The government is likely to pursue symbolic measures to try to cushion the blow for exporters, but it is clearly impossible to try to maintain exports when Western demand has collapsed, he said. The Chinese authorities have been adopting measures to drive low value-added export production out of the Pearl River and Yangtze Delta regions for some time already, said Simon Ogus, CEO of DGS Asia. The collapse

in external demand will just speed the process, he said. While some have called for China to depreciate the RMB, doing so would not help exporters, said Royal Bank of Scotland (RBS) economist Ben Simpfendorfer, and would encourage capital flight. Others were not so confident. HSBC's Neumann and Asianomics' Walker both predicted the RMB would lose value against the U.S. dollar later this year as the Chinese authorities attempt to offset real effective exchange rate appreciation vis--vis regional currencies.

¶9. The declining fortunes of the export sector would be less of a concern if there weren't millions of migrant workers forced out of work, said Bank of China International (BOCI) Managing Director Anthony Lok. With estimates of up to 35 million unemployed by the end of 2009, the Chinese authorities are worried that the potential for unrest is increasing, said Lok. But RBS's Simpfendorfer disagreed, noting that migrant worker demonstrations in Guangdong over the past several months have been directed at factory owners, not the government. With large numbers of migrant workers scattered throughout their home provinces after the Lunar New Year holiday, it is difficult for them to organize. In any event, food prices have traditionally been more likely than unemployment to spark unrest directed at the government, he said. The central government will increase security around key events such as the National People's Congress (NPC) and other important anniversaries, said Goldman Sachs economist Helen Qiao. She added that the burden of providing jobs, training or other activities for unemployed migrants is likely to fall on local governments.

Restructuring before Rebalancing

¶10. Analysts and observers agree that China cannot rely on a rapid rebound of external demand to save the export sector. The Chinese economy has been structurally misaligned for many years, said Asianomics' Walker. Low interest rates and an undervalued exchange rate have encouraged massive investment in capital intensive export manufacturing and a lack of production for the domestic market. Low rates of domestic consumption have been held down by unnaturally high rates of investment and the dismantling of the Chinese social safety net, he said. Boosting domestic consumption in China will take years, said Simpfendorfer, and will have to begin with increasing government spending on health and education.

¶11. BOCI's Lok agreed, adding that inadequate distribution networks make increasing domestic demand more challenging. He noted that many exporters benefit from VAT rebates on imported components, making production for the domestic market more costly. DGS' Ogus added that the large number of Chinese companies dependent on the export sector makes it difficult to increase domestic consumption during an economic downturn. Anticipated and actual job losses in this important sector will reduce incentives to consume more. Goldman Sachs' Qiao dismissed Chinese government "electronics for the countryside" program as ineffective, subject to corruption and manipulation, and unlikely to produce any real increases in rural consumption. Spending on health and social security is just one percent of the central government's stimulus program, she said. As long as the Chinese consumers are still worried about the cost of education, health care and retirement, they will be unwilling to significantly increase spending.

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